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City Council
 City of Carlsbad
 Carlsbad, California

In planning and performing our audit of the financial statements of the City of Carlsbad (the "City") as of and for the year ended June 30, 2009, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is defined to be a control deficiency, or combination of control deficiencies, that adversely affects the City's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the City's financial statements that is more than inconsequential will not be prevented or detected by the City's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. **We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.**

We observed the following other matters, which were not deemed to be significant deficiencies or material weaknesses and offer these comments and suggestions.

1. Formation of a Formal Ethics Policy

We evaluated the City's conformance to the best practices recommended by the Auditing Standards Board as a part of the new auditing standards that take effect for 2009 audits. We noted that the City already has in place a number of practices to communicate its expectation of ethical behavior to all employees through verbal communications, trainings, and by setting proper tone at the top. However our audit procedures revealed the City does not have a formalized ethics policy. A well structured ethics policy establishes organizational standards for ethics, morals, and an overall "regard for the rules" philosophical approach within an entity. Specifically, matters such as honesty, integrity, compliance with laws and regulations,

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adherence to corporate policy, and upholding the City's high values and reputation are addressed. We also noted that the City's practices do not include a clearly communicated process for employees to report suspected fraud or other unethical conduct. A strong ethics policy is the foundation upon which an Organization builds its culture, which should then permeate all levels of personnel and guide all business dealings and transactions. This can be most effective in establishing a highly ethical and antifraud culture within any business organization.

Recommendation

We recommend that the City establish and implement an ethics policy. We also suggest that the City implement an effective reporting mechanism for fraud and other unethical conduct. Internal reporting channels, such as managers' open-door policy, hotlines for anonymous tips, or a clearly defined reporting protocol (what to report, who to report to, etc.), have been found to be effective.

City Response

The City concurs that a more formalized ethics and reporting mechanism for fraud and other unethical conduct be documented. During Fiscal Year 2008-09 the City began documenting these various policies. A team of appropriate stakeholders was formed and began to determine the City's current practices and future needs associated with an ethics policy. The City will continue to develop a more formalized ethics policy.

2. Strengthening Controls in the Grant Administration Area

The City of Carlsbad receives over \$8 million in federal funding on an annual basis. These federal funds are subject to various compliance and reimbursement requirements. We noted certain opportunities in the grant administration area where internal controls could be enhanced to ensure that these federal requirements are met:

- Procedures should be in place for all programs to ensure that reimbursement claims are submitted timely. For most of the cost reimbursement grants, reimbursement claims are submitted relatively timely. However, it was noted that certain HOME project expenditure incurred in July 2008 had not been claimed for reimbursement until September 2009. Lengthy delays in submitting reimbursement claims to granting agencies increases the risk of costs not being reimbursed. It also impacts the City's investment earnings as cash outflows for grant activity are not being reimbursed and reinvested timely.
- The City receives its HOME grant funding through the County of San Diego. Per the cooperative agreement between City and the County, the City is required to submit a quarterly progress report to the County. However, the last quarterly report was submitted in January 2005 and no additional quarterly progress reports had been submitted since then as it is the understanding of the City that these reports are not longer required. The City

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should make efforts to obtain written confirmation from the County to support their understanding that this written reporting requirement is no longer applicable to this program.

- Annually the City will prepare a summary of all federal expenditures, known as the Schedule of Expenditures of Federal Awards, and this summary is used by the auditors to determine the extent of federal testwork needed. It was noted that \$689,393 of federal expenditures incurred in the prior year had not been included on the 2008 Schedule of Expenditures of Federal Awards. These HOME program expenditures were subsequently tested during the 2009 audit. Efforts should be made to ensure that the summary of federal expenditures includes all federal expenditures incurred in a given fiscal year.
- The City receives over \$6 million in federal funds under the Housing Choice Voucher program. The Housing Manager is responsible for reviewing housing assistance payments that are calculated based upon tenant data in Visual HOMES system. Tenant information and updates are entered into the Visual HOMES system by the housing staff. Changes to the tenant information are reviewed and approved by the Housing Manager. It was also noted that the Housing Manager also has the ability to make changes to the tenant database (which includes adding new tenants). Controls would be stronger if the Housing Manager did not have "user access" in the Visual HOMES system. The best practice would be to segregate the functions of adding new tenants and reviewing changes to the tenant database. The person who reviews changes to tenant database should not have the ability to make changes.

Recommendations

To enhance controls in the grant administration area, we offer the following suggestions for consideration:

- The City should consider assigning an individual the responsibility of monitoring reimbursements submitted for the significant grant programs to ensure that efforts are being made to submit reimbursement requests to granting agencies in a timelier manner.
- The written requirement to submit quarterly progress reports for the HOME program should be adhered to until written clarification, or an agreement amendment, is received from the County.
- Efforts should be made by the appropriate departments to ensure that complete grant information is provided to the Finance Department for the annual preparation of the Schedule of Expenditures of Federal Awards.
- To further enhance the City's internal controls, we recommend that the person who reviews changes to the tenant information not have the ability to add new tenants into the Visual HOMES system.

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City Response

- Procedures are in place to ensure that reimbursement claims are submitted timely. The reimbursement to the County of San Diego for the expenditure mentioned, however, was in fact delayed due in part to the uniqueness of the project. Because Habitat for Humanity has a very lengthy selection process for homebuyers, the City was unable to provide the County with the data needed to complete reports required by HUD to close out an account and reimburse funds to the County. Although the funds were needed to construct the residential units, the City did not have all the required information to be able to submit for reimbursement. Therefore, the reimbursement request to the County was delayed. As noted, however, this is a very unusual situation. The City does not expect this type of issue in the future. It is important to note that the City has assigned an individual with the responsibility of monitoring reimbursements to ensure that they are made in a timely manner in response to the suggestion made.
- In the past, the requirement from the City's HOME Cooperative Agreement regarding submittal of quarterly progress reports has always been accomplished through a procedure in which the County sends each city a report form that has been partially completed by the County with pertinent information on the city, reporting dates, and grant amounts. Cities then completed the rest of the form and returned it to the County. Work load increases and other priority projects prevented County staff from continuing with this established procedure and City staff assumed that the reports were no longer needed by County staff. City staff brought this concern/recommendation to the attention of County staff and the report submittal procedure will be re-established to meet the agreement requirement.
- The City has assigned Finance liaisons to every department within the City. These Finance representatives will be responsible for working with departments to ensure that complete grant information is provided to the Finance Department and to assist in the tracking of all grant information for the annual preparation of the Schedule of Expenditures of Federal Awards.
- The City is considering and investigating the suggestion to segregate the functions of adding new tenants and reviewing changes to the tenant database. As feasible and appropriate, changes will be made to address this suggestion.

We appreciate the opportunity to present these comments and suggestions and can discuss these matters further at your convenience, along with any implementation assistance for changes and improvements you may require.

This communication is intended solely for the information and use of management, City Council, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

Mayor Hoffman McClain P.C.

Irvine, California
November 6, 2009